Governance and Oversight – Fiduciary Imperatives in a Volatile Era

September 19, 2025

Introduction

In our last chapter, we examined how investment strategy can be aligned with liability needs. This final installment addresses the governance gap, where trustees, actuaries, consultants, and money managers operate in silos, undermining coordinated risk management. We propose a framework for fiduciary oversight and strategic alignment.

Key Topics

- Stress testing and scenario analysis as governance tools
- Segmented investment policies for actives vs. retirees
- Independent Actuarial review
- Dynamic asset allocation

Takeaway

Fulfilling fiduciary duty requires more than good intentions; it demands informed governance, strategic foresight, and coordinated execution. Trustees must act before the next crisis, not during it.

Fiduciary Responsibility and Risk Mitigation in Pension Governance

Trustees of pension plans bear a profound fiduciary duty: to act prudently and in the best interest of plan beneficiaries. This responsibility extends beyond investment performance; it includes ensuring that the plan can meet its benefit obligations under all market conditions. One of the most overlooked yet consequential risks is cash flow risk, especially in mature plans where benefit payments exceed contributions.

An over-reliance on equity markets exposes plans to unnecessary volatility. During market downturns, forced liquidation of equities to meet benefit payments can trigger a downward spiral in funding levels and exacerbate deficits. This sequence of returns risk, where poor performance early in the decumulation phase causes lasting damage, is particularly acute in plans with negative cash flow.

The Governance Gap: Awareness and Coordination

Despite the gravity of these risks, many trustees remain unaware of the underlying issues. Fixed income allocations are often made without a clear understanding of the plan's cash flow needs. Moreover, investment consultants and actuaries frequently operate in silos, failing to collaborate on integrated strategies that align assets with liabilities.

This governance gap undermines the trustees' ability to fulfill their fiduciary obligations. Without coordinated advice and clear visibility into future cash flows, trustees may inadvertently expose the plan to avoidable risks.

Actionable Solutions: Independent Oversight and Strategic Alignment

To address this, trustees should consider engaging an independent actuarial consultant to run detailed projections and stress tests. This consultant can help:

- Ensure trustees are asking the right questions
- Improve trustees understanding of embedded risks in the pension plan which they are required to manage
- Quantify cash flow needs and align them with fixed income maturities.
- Evaluate asset-liability matching strategies, including cash flow matching and duration matching.
- Facilitate collaboration between actuaries and investment advisors.
- Implement governance triggers that prompt action when funding levels deteriorate.

Stress Testing and Scenario Analysis: A Pillar of Pension Risk Management

Stress testing and scenario analysis are essential tools for trustees and investment committees seeking to understand how pension plans will perform under adverse market conditions. These methodologies help quantify vulnerabilities, guide strategic decisions, and ensure that plans remain solvent and resilient, even during economic shocks.

Stress testing and scenario analysis are not just technical exercises, they are strategic imperatives. They help trustees:

- Understand how market shocks affect funding and liquidity.
- Align investment strategies with liability profiles.
- Evaluate the impact of economic scenarios on contribution requirements.
- Make informed decisions that protect retiree benefits and ensure long-term solvency.

Investment Policy: Rethinking Risk in Mature Pension Plans

As pension plans mature, their investment policy should evolve to reflect the changing nature of their obligations. Mature plans, much like retirees, have limited time horizons, predictable liabilities, and a reduced capacity to recover from market downturns. Yet many continue to pursue aggressive return targets that expose them to unnecessary risk.

1. Actuarial Tools Enable Smarter Risk Alignment

Advancements in actuarial modeling now allow for the use of differentiated interest rates when measuring liabilities. This flexibility enables trustees to align investment strategy with a more conservative risk posture without compromising the integrity of funding projections. These tools open the door to more tailored investment strategies that reflect the plan's maturity and cash flow profile.

2. The Myth of Unlimited Risk Tolerance

While some argue that pension plans can absorb more risk than individual retirees, history tells a different story. The collapse of numerous multiemployer plans, particularly after the 2008 financial crisis, demonstrates that there is a hard limit to how much volatility a plan can withstand. These failures were not due to poor returns alone, but to the mismatch between asset volatility and liability certainty.

3. Balancing Return Expectations with Actuarial Assumptions

There is a natural tension between chasing returns and adhering to actuarial assumptions. However, if trustees choose to reduce portfolio risk, actuaries can adjust their assumptions accordingly. This coordinated approach allows the plan to move toward a more stable and sustainable future; this alignment is key to long-term solvency.

4. Peer Comparisons: A Misguided Benchmark

Trustees often feel pressure to match or exceed the returns of peer plans. But this mindset can lead to excessive risk-taking. The real benchmark should be the plan's ability to meet its benefit obligations; not outperforming another plan's return. As we have argued, fiduciary responsibility demands a focus on benefit security, not relative performance.

Dynamic Asset Allocation: A Targeted Approach to Managing Negative Cash Flow Risk

As pension plans mature, the divergence between active participants and retirees becomes more pronounced - not just demographically, but financially. Active members contribute to the plan and generate positive cash flow. Retirees receive benefits but do not contribute, leading to ongoing negative cash flow. This structural imbalance demands a differentiated investment approach.

Segmented Investment Policy: One Plan, Two Strategies

It is both logical and prudent to establish separate investment policies for the assets supporting actives and those supporting retirees:

- **Retirees (Cash Flow Negative):** These assets should prioritize liquidity, stability, and liability matching. Fixed income instruments, especially those aligned with benefit payment schedules, are essential.
- **Actives (Cash Flow Positive):** These assets can tolerate more risk and longer investment horizons. Equities and growth-oriented strategies are appropriate here.

This bifurcated approach aligns investment risk with the cash flow realities of each group, reducing the likelihood of forced asset sales during market downturns.

Conclusion: A Fiduciary Imperative

Pension trustees must recognize that managing negative cash flow is not just a technical concern; it is a fiduciary responsibility. Relying solely on equities without a structured liquidity strategy exposes the plan to sequence-of-returns risk and potential funding crises. A proactive approach, anchored in cash matching and dynamic asset allocation, can preserve capital, protect retiree benefits, and ensure long-term solvency.

In this series of white papers, we have seen that a portfolio with a lower average return may provide better results since mature plans are more sensitive to timing of returns rather than the average return.

We have also discussed the idea of using the current fixed income allocation to work for the plan and add more protection rather than just a buffer against equity return volatility.

As plans mature over time, investment allocation should adjust accordingly, similar to the adjustments made in 401(k) plans. Consider how target date funds derisk as participants near retirement age.

Minor changes can provide substantial protection for the plan.

Best Practices for Trustees

1. Adopt Dynamic Triggers

Implement glide paths that automatically reduce equity exposure as the plan matures. Reallocate gains from equity outperformance into fixed income assets that support liability cash flows. Dynamic allocation can reduce volatility and stabilize contributions.

2. Stress-Test Scenarios

Avoid relying on fixed return projections, which mask volatility and mislead trustees. Instead, use Monte Carlo simulations and scenario analysis to model a range of economic outcomes. Variable return modeling reveals hidden risks and helps trustees prepare for adverse conditions.

3. Liability Driven Investing (LDI)

Rather than using aggregate bond index funds for the fixed income portfolio, consider using fixed income instruments to hedge retiree liabilities. This can help not only buffer total return performance but also better hedge interest rate changes and help manage cash flow demands of the plan.

4. Independent Actuarial Review

Engage an independent actuary to evaluate the plan's cash flow profile, investment strategy, and governance structure. They can assist in performing independent projections and review other projections. This third-party perspective can uncover blind spots and ensure that fiduciary responsibilities are being met. Such reviews can also help address political pressures and stakeholder concerns.

Trustees face many challenges and risks in managing pension plans. But the most significant risks are the risks they don't see or know about.

Self Examination

Pension trustees need to be vigilant about monitoring risks in the pension plans they oversee. They must also trust their professionals to be on top of these risks and working together to monitor these risks.

To assist trustees, we have put together a simple Pension Plan Risk Metrics scorecard for trustees to perform self examination of their plans and discuss the results with their professionals or contact the authors of this whitepaper series.

The evaluation spreadsheet can be found at the link below and is designed to be easy to use and perform simple high level risk analysis of the plan. With just a few inputs from the actuarial valuation report, the analysis will perform a few quick calculations and determine if there are any areas of risk the trustees should discuss in more detail.

The lower the overall score, the less risky the plan is and the higher the score the more risky the plan is. Again, the risk does not necessarily mean the plan is in jeopardy, just that the trustees should be diligent in reviewing these risks to ensure they are managed properly.

Pension Plan Risk Metrics.xlsm

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